Forex Focus: Policy Divide Makes Currencies Less Predictable

By Nicholas Hastings

A DOW JONES NEWSWIRES COLUMN

LONDON (Dow Jones)--Currency forecasting just became even more unpredictable.

As most major global economies continue to stumble out of recession, not only are disagreements on monetary policy becoming more acute but the divisions on currency policy are becoming even wider.

No doubt G-7 finance ministers meeting on the fringes of the International Monetary Fund bi-annual summit in Washington this weekend will be anxious to patch over the yawning gaps.

If anything, they will be trying to come up with a more united approach that they can take to the wider G-20 meeting in South Korea next month.

However, growing uncertainty over policy direction and increasing doubts about which one would be successful are making life that much harder for currency investors.

Take monetary policy first.

The U.S., the U.K. and Japan feel the best way to avoid a double-dip recession is to increase market liquidity even more. The Federal Reserve, the Bank of England and the Bank of Japan are all lining up to do just this, each in their own way.

In the euro zone, however, the much more inflation-conscious European Central Bank is suggesting that enough is enough. Despite continued signs of severe financial pressure on heavy debtors such as Ireland and Spain, there is little sign that the ECB is about to provide any more help.

On the contrary, the bank's members appear keen to continue their exit from non-standard liquidity measures at the same time that former Nobel prize winner Joseph Stiglitz is warning that the austerity measures being taken across the region could trigger a new recession. In fact, Stiglitz warned about the future of the single currency itself.

So, while the ECB's hawkish stance may have been helping the single currency for now, this support could soon wane, if the strength of the euro is thought to be hampering the region's recovery even more.

On top of that, there is the growing divide between the interveners and the non-interveners. In other words, those like the U.S. which profess a free-market floating approach to currency movements and those, like China and many other Far Eastern countries, that are only too happy to interfere in their currency's performance when it suits them.

The whole issue has been highlighted by the weakness of the global recovery and the threat of competitive devaluations to keep export growth alive.

Certainly, the economic success of China, which keeps its currency on a very short leash, and the strength of many smaller Far Eastern countries, which have kept a lid on the advance of their currencies, all attest to the success of currency manipulation.

It isn't surprising to learn that the French have apparently been in secret talks with China for the last year on ways to stabilize international currency movements through policy coordination.

Although Elysee Palace has denied any such talks, they will hardly strike a happy chord in Washington, as the government struggles to keep the U.S. economy afloat.

Also, the Institute of International Finance, which represents 420 leading banks, has called for a new currency pact to help prevent a growth in protectionism.

So far, China has refused to cooperate with the U.S., by keeping its currency on a very gradual rising peg that ensures that Chinese exports remains competitive in the U.S.

Now, Beijing seems to be turning its attention to the euro zone too, pledging support both for a stable euro and for euro-zone bond markets.

Given that China's trade with the euro zone is larger than with the U.S., a stable and firm euro is certainly in China's interest.

As the battle over fixed and floating--or even just coordinated--exchange rate regimes continue, the ability to predict the direction of major currency pairs could prove that much more difficult.

In an effort to halt its currency's recent strength, the Bank of Japan cuts its key lending rate effectively to zero from 0.1% earlier Monday, helping the dollar to bounce a little to Y83.70 by 0645 GMT from Y83.44 late Monday in New York, according to EBS.

See how Japan has struggled with the dollar's decline against the yen:

http://www.dowjoneswebservices.com/chart/view/4679

The euro also rose to Y114.68 from Y114.20 and also ticked up to $1.3701 from $1.3690.

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